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in the

SUPREME COURT

of the

UNITED STATES

October Term, 1984

AUGUST URBANEK, ESTATE OF IRENE URBANEK, DECEASED, AUGUST URBANEK, PERSONAL REPRESENTATIVE

Petitioner

v.

THE UNITED STATES

Respondent

PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FEDERAL CIRCUIT

MELVIN N. GREENBERG, ESQ.
MARLENE K. SILVERMAN,
Attorney at Law and
Counsel of Record
GREENBERG, TRAURIG, ASKEW,
HOFFMAN, LIPOFF, ROSEN
& QUENTEL, P.A.
1401 Brickell Avenue, PH-1
Miami, Florida 33131
(305) 579-0619

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PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FEDERAL CIRCUIT

QUESTIONS PRESENTED FOR REVIEW

1. Is the Welsh Homes cost-allocation formula applicable to condominium sales?

2. Can an appellate court properly take judicial notice of accounting practices and thereby decide whether a taxpayer has followed correct accounting procedure when the issue was not raised in the lower court or by either party on appeal?

PARTIES

August Urbanek -- Plaintiff

Estate of Irene Urbanek,
Deceased, August Urbanek,
Personal Representative -- Plaintiff

The United States -- Defendant

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JURISDICTION

The judgment of the United States Court of Appeals for the Federal Circuit was entered on April 6, 1984. (Appendix, p. 36, infra). A timely petition for rehearing and suggestion for rehearing in banc was denied on May 8, 1984 (Appendix, p. 38, infra), and this petition for certiorari was filed within 90

days of that date. The jurisdiction of this Court is invoked under 28 U.S.C. §1254(1) (1976).

STATUTES AND REGULATIONS INVOLVED

The pertinent statutes and regulations involved in this case are: Section 61 of the Internal Revenue Code of 1954, as amended in 1972, 26 U.S.C. §61 (1976); Section 1012 of the Internal Revenue Code of 1954, as amended in 1972, 26 U.S.C. §1012 (1976); Treas. Reg. §1.61-3(a) (1954); Treas. Reg. §1.61-6(a) (1954); FED. R. EVID. 201(b); FED. R. EVID. 201(e). (Appendix, p. 75 through 84, infra).

STATEMENT OF THE CASE

In 1969 taxpayer, August Urbanek, formed a partnership to develop a 5.5

acre tract of land in Boca Raton, Florida.[1] The project, eventually known as Boca Towers, called for the construction of two condominium towers on .9 acre located roughly in the middle of the tract. On the surrounding land, the partnership constructed various amenities such as a parking lot, a putting green, a swimming pool and a marina.

Sales of condominium units followed a pattern which was not uncommon to developments in Florida. Each buyer received fee simple title to his condominium and to a pro rata share of a

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[1]The factual background of the case detailed herein was set forth in the opinions delivered in the courts below and in the stipulation of the parties, which was part of the joint appendix filed in the court of appeals. Reference to the joint appendix will be designated as "Jt. App.".

package consisting of the land on which the towers were located, of a road connecting the towers with the public street and of the amenities.

The partnership retained title to the approximately 4.6 acres which surrounded the towers and upon which the amenities were situated. The retained land was leased for a 99 year nonrenewable term to the Boca Towers Condominium Association, a nonprofit Florida corporation formed by Urbanek and his partner in 1971.

The association agreed to a yearly net rental of approximately $160,000.00, with periodic increases geared to the consumer price index.[2] The lease was

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[2]The $160,000.00 rental was determined by Urbanek and his partner in the following man- (Continued)

negotiated between the partnership and the association at a time when Urbanek and his partner were in control of both. Buyers of condominium units were required to become members of the association and to assume a pro rata share of the ground lease. Each buyer pledged his condominium as security for performance of his obligations under the lease.

The partnership decided to lease rather than sell the land underlying the amenities so as to keep the sales price and down-payments required for unit purchases as affordable as possible. This

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ner: they determined that the fair market value of the leased land was about 1.6 million dollars as of June 1, 1971. They further determined that the prevailing fair market ground rentals in the Boca Raton area were equal to 10% of the fair market value of the leased land. The $160,000.00 rent was predicated on the ability to sell all 272 of the condominium units. (Jt. App. at p. 67).

arrangement was then prevalent in the Boca Raton area and one which Urbanek had successfully utilized in his earlier developments.

At this time, Boca Raton limited the density of residential construction to 50.7 units per acre. This meant that the larger a tract of land a developer had, the more condominium units he could build. Construction, however, did not have to be evenly distributed over the tract. As in this case, the residential units could be concentrated in high-rise towers on a small portion of the land, so long as sufficient total land was dedicated to the project.

The partnership sold the condominium units starting in 1972. In calculating and reporting the gain from the

sale of these units, the partnership subtracted from the sales price the cost of the .9 acre of land on which the towers were situated, plus the full cost of erecting the towers and the amenities, all of which were sold to the condominium purchasers. Utilizing this method of computation, Urbanek reported his 50% share of the distributive income from the partnership on joint federal income tax returns for calendar years 1971 to 1975. (Jt. App. at p. 80).

After statutory notice, the Commissioner of Internal Revenue assessed against August and Irene Urbanek an asserted deficiency of $173,268.43 for the calendar year 1972. (Jt. App. at p. 59). Urbanek paid the alleged deficiency, unsuccessfully sought a refund

through the Internal Revenue Service's administrative procedures (Jt. App. at p. 59-60), and on March 23, 1979 filed an action in the United States Court of Claims pursuant to 28 U.S.C. §1491 to recover the sums paid. The case was transferred to the Claims Court pursuant to the Federal Courts Improvement Act of 1982, Pub. L. No. 97-164, 96 Stat. 25 (1982).

On June 3, 1983 the Claims Court filed an opinion in the government's favor. Without ever finding that Urbanek used the lease to defer income, the court nevertheless held that his cost allocation did not "reflect reality" and that his cost basis in the property sold should be lowered and his gain on sale thereby increased in ac-

cordance with a formula described in Welsh Homes, Inc. v. Commissioner, 279 F.2d 391 (4th Cir. 1960).[3] (Appendix, p. 42, infra). It did so despite acknowledging from the bench that Urbanek "was acting in a manner which was truly fair and truly honest and with no intent to distort income or to in any way cheat the Government." (Jt. App. at p. 496). Judgment in accordance with the opinion was entered on July 18, 1983. (Appendix, p. 71, infra).

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[3]The Welsh Homes formula first divides the sales price of the units by the aggregate value of the property which consists of the sales price plus the value of the lease. The resulting ratio is applied to the project costs to determine what portion should be allocated to the sale and what portion should be allocated to the lease. The application of the Welsh Homes formula resulted in a reallocation of some of the costs of construction of the property sold to the lease, thereby lowering the cost basis of the units sold.

On August 2, 1983, Urbanek timely filed a notice of appeal to the United States Court of Appeals for the Federal Circuit. Jurisdiction was predicated upon 28 U.S.C. §1295(a)(3). On April 6, 1984, a divided panel of the court affirmed the Claims Court's judgment. (Appendix, p. 1, infra). Urbanek's petition for rehearing and suggestion for rehearing in banc was denied by the Court on May 8, 1984, over the objection of Circuit Judge Bennett. (Appendix, p. 38, infra).

REASONS FOR GRANTING THE WRIT

INTRODUCTION

This case has set a significant precedent in the taxation of condominium sales and creates implications which extend throughout the field of income taxation. It marks the first time that the cost-allocation formula approved in Welsh Homes, Inc. v. Commissioner, 279 F.2d 391 (4th Cir. 1960) has been applied outside the limited context of a Maryland ground rent-type transaction. Prior to the decisions below, it appeared that in the calculation of the cost of goods sold, a taxpayer could allocate to the interest sold the costs associated with that interest.

The extension of the previously limited and anachronistic decision in

Welsh Homes into a major new tax doctrine is an issue of extreme significance to real estate developers and to all taxpayers who receive both immediate and deferred income from a project. Such a sweeping change in taxation, which conflicts with principles established by a prior decision of this Court and that of another court of appeals, should come, if at all, only from Congress. It should not come from an appellate court whose decision was primarily based upon "correct accounting practices", of which it improperly took judicial notice.

I.

THE DECISION BELOW CONFLICTS WITH THIS COURT'S DECISION IN FRANK LYON CO. v. UNITED STATES.

In Frank Lyon Co. v. United States, 435 U.S. 561, 583-84 (1978), this Court stated:

> [W]here . . . there is a genuine multiple-party transaction with economic substance which is compelled or encouraged by business or regulatory realities, is imbued with tax-independent considerations, and is not shaped solely by tax-avoidance features that have meaningless labels attached, the Government should honor the allocation of rights and duties effectuated by the parties.

The decision of the Court of Appeals for the Federal Circuit has plainly departed from this Court's holding in Frank Lyon Co. "[T]he plain reality of attributing costs to the interests to which they

relate[d] [was] ignored, and used in its stead [was] a wholly arbitrary means of allocating costs according to values without any recognition of the substance of the arrangement that the taxpayer utilized". (Dissent, Appendix, p. 27, infra.)

The uncontradicted evidence at trial established that the division of the transaction under review into separate sale and lease components was a prevalent arrangement in the Boca Raton area and was utilized by the taxpayer and others for the legitimate business purpose of lowering the purchase price of the condominium units to facilitate their sale. The court of appeals made clear that it was not challenging the independent business reasons for struc-

turing the transaction in this manner and was not resting on any tax avoidance or deferral features. (Appendix, p. 9, infra):

> Our conclusion is stated with full recognition that the bona fides of appellant's method is not in question. However, irrespective of tax avoidance (or postponement) considerations, reallocation may be deemed proper. Central Cuba Sugar Co. v. Commissioner, 198 F. 2d 214, 215 (2d. Cir. 1952). (footnotes omitted).

Although this statement of the law may have been correct at the time Central Cuba Sugar Co. v. Commissioner was decided, it cannot be considered authoritative after this Court's decision in Frank Lyon Co. Without rejecting the bona fides of the taxpayer's transaction and without finding any tax avoidance or postponement, a court can-

not sanction the government's rejection of a taxpayer's allocation simply to produce more immediately taxable income. Therefore, Judge Bennett, in his dissenting opinion, was correct in concluding:

> The government has ignored the Supreme Court's admonition in this case, as the application of the Welsh Homes formula effectively restructures the transaction entered into by the taxpayer by allocating a portion of the cost of the improvements, which were sold in fee simple, to the interest retained by the taxpayer.

(Dissent, Appendix, p. 28, infra). Certainly, the scope of the Commissioner's authority and that of the courts after Frank Lyon Co. is an issue of sufficient importance to justify consideration by this Court.

II.

THE DECISION MAKES A SWEEPING CHANGE IN THE TAXATION OF CONDOMINIUM SALES WHICH CONFLICTS WITH THE PLAIN LANGUAGE OF THE INTERNAL REVENUE CODE AND THE DECISION OF ANOTHER COURT OF APPEALS

The Internal Revenue Code and the regulations promulgated thereunder make it clear that a taxpayer is entitled to deduct the actual cost of goods sold in arriving at his gain. I.R.C. §61(a)(2) (1976); I.R.C. §1012 (1976). Treas. Reg. §1.61-3(a) (1954); Treas. Reg. §1.61-6(a) (1954). It follows that Urbanek was fully entitled to deduct as the cost of goods sold, the full cost of constructing the units conveyed, a pro rata share of the cost of the amenities for the 108 units sold in 1972, and a pro rata share of the land underlying

the units. The entire cost basis was properly deductible since Urbanek retained no interest in the units, in the land on which they were built or in the amenities on the surrounding land. Urbanek did not add to the cost basis any portion of the cost of the 4.6 acres which was retained subject to the ground lease. Hence, every dollar of cost attributed to the cost of goods sold was totally and irrevocably conveyed to condominium purchasers. As observed by Judge Bennett in his dissenting opinion, "[t]his allocation has a basis both in common sense and tax law, and serves as an affirmation of the principle that the term 'cost of goods sold' means just that." (Dissent, Appendix, pp. 22-23, infra). (footnote omitted).

This case marks the first time that such a straight-forward cost allocation has been rejected, and also the first time that the Welsh Homes formula has been approved by an appellate court outside the unique area of Maryland ground rent-type transactions. In Welsh Homes, a special cost allocation formula was necessary because property interests in both the building and the underlying land were simultaneously retained and conveyed, and thus, as the Fourth Circuit Court of Appeals stressed, the cost of the leasehold interest carved out of the whole "cannot be definitely shown". 279 F.2d at 394. In this case, Urbanek did not carve a leasehold out of the whole of the improvements sold. The entire fee simple interest in the .9

acre and improvements were conveyed and the cost of such land and improvements are specifically known. Conversely, the property which was leased was retained in its entirety. Since here, unlike in Welsh Homes, all costs can be traced to their respective property interests, the predicate for application of the Welsh Homes formula is conspicuously absent.

The court's treatment of petitioner also conflicts with the treatment afforded similar developers in the Fifth Circuit. In Murry v. Commissioner, 601 F.2d 892 (5th Cir. 1979), the court was presented with facts strikingly similar to those at issue here. The developer, a corporation in which taxpayer was one of three shareholders, purchased a parcel of land upon part of which buildings

were constructed and part of which was dedicated to recreational facilities and leased for 99 years through a condominium association. The lease was subsequently assumed by unit purchasers. The court of appeals rejected the Commissioner's attempt to disregard the actual transaction and capitalize admittedly excessive portions of the rents paid under a ground lease.[4] Al-

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[4]Here, unlike in Murry where the corporate developer recognized a loss on the sale of the condominium unit, the partnership realized and recognized a gross profit of $528,681 in 1972 and $1,627,876 for 1971 through 1975. (Jt. App. at p. 78-79). Thus, the partnership reported a gross profit of approximately 17% for years 1971 through 1975, and 15% for 1972 alone. Moreover, Urbanek, unlike the taxpayer in Murry, presented uncontradicted evidence at trial that the ground lease rent did not exceed the fair market value of the 4.6 acres. The Claims Court's conclusion that the 4.6 acres was worth less than $1,600,000 was based on its mistaken analysis that the value of the leased land was indeterminate as a matter of law because its condominium (Continued)

though Welsh Homes was not argued, the Fifth Circuit made clear, relying on Frank Lyon Co., that the government could not restructure the transaction.

The Fifth Circuit described the government's position in Murry as follows:

> [W]e are asked to embark upon a new course altogether, giving the Commissioner the authority to restructure a transaction into the transaction the Commissioner would deem more appropriate. Such authority in government would be wholly unprecedented.
>
> * * *
>
> In short, the Commissioner's position is that, when a taxpayer or related taxpayers, have entered into actual transactions, the Commissioner should be authorized to rule that the taxpayer ought not have made those particular transactions but should have entered into different transactions so that more immediately taxable income would

> result. Under this view, when the Commissioner determines that the taxpayer has, in a bona fide transaction, minimized the tax consequences, Section 61 of the Internal Revenue Code authorizes the Commissioner to create the sort of transaction which would have maximized the taxable consequences and, having done so, to treat the taxpayer as if he had, indeed, entered into the transaction the Commissioner prefers.

601 F.2d at 893. The new course feared and rejected by the Fifth Circuit is precisely the course that the court below has authorized. It was, at the time of the decision in Murry, and is today, "wholly unprecedented".

III.

THE DECISION SETS SIGNIFICANT AND NOVEL PRECEDENT WHICH IS MORE PROPERLY LEFT TO CONGRESS

This case sets precedent on a question of exceptional importance, for which review on certiorari is appropriate under Rule 17 of the rules of this Court. The importance of the decision below is evident since many developers have followed the same practice as Urbanek. Moreover, the Claims Court stated, and the Federal Circuit apparently agreed, that the Welsh Homes allocation formula it adopted goes beyond real estate transactions and "would appear to be applicable whenever a taxpayer singles out for separate treatment an integral portion of a transaction . . . and obtains for it

rental income or other deferred compensation." (Appendix, pp. 61-62, infra).

Even if there were a plausible rationale for so applying the Welsh Homes formula, such a change in the law should come from Congress rather than the courts. As this Court stated in United States v. Byrum, 408 U.S. 125, 135 (1972):

> Courts properly have been reluctant to depart from an interpretation of tax law which has been generally accepted when the departure could have potentially far-reaching consequences. When a principle of taxation requires re-examination, Congress is better equipped than a court to define precisely the type of conduct which results in tax consequences. When courts readily undertake such tasks, taxpayers may not rely with assurance on what appear to be established rules lest they be subsequently overturned. Legislative enactments, on the other hand, although not al-

> ways free from ambiguity, at least afford the taxpayers advance warning.

The traditional method of cost allocation has long been settled. In light of the holdings in Murry and other such cases,[5] taxpayers such as Urbanek have justifiably believed that they may structure transactions along the lines that were chosen. By reallocating costs, the Court of Appeals for the Federal Circuit has superimposed a new level of complexity and uncertainty as to what was previously the clear right of the taxpayer to deduct the actual cost of goods sold in computing gain. See Treas. Reg. §1.61-6(a) (1954).

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[5]See, e.g., Mangurian v. Commissioner, 38 T.C.M. (CCH) 366 (1979); and Friedman v. Commissioner, 36 T.C.M. (CCH) 841 (1977).

The warrant for action by this Court was best stated in the conclusion to Judge Bennett's dissenting opinion (Appendix, pp. 34-35, infra):

> The application of the Welsh Homes formula to this case is clearly unwarranted under existing tax law. Such a sweeping change in the taxation of condominium sales should come, if at all, from Congress, and not from 'creative' judicial opinions. (citations omitted).

IV.

THE DECISION CONSTITUTES AN UNPRECEDENTED EXPANSION OF JUDICIAL NOTICE AND VIOLATES THE FEDERAL RULES OF EVIDENCE

It is fundamental that a high degree of indisputability is the essential prerequisite for judicial notice. FED. R. EVID. 201(b) ("A judicially noticed fact must be one not subject to reasonable dispute . . ."). See also

Hardy v. Johns-Manville Sales Corp., 681 F.2d 334 (5th Cir. 1982); Sayers v. Gardner, 380 F.2d 940 (6th Cir. 1967). The Federal Circuit's decision departed from this maxim, and also violated the procedures for taking judicial notice of adjudicative facts set forth in FED. R. EVID. 201. The court took judicial notice of certain accounting texts to support the proposition that the government's proposed cost allocation formula followed correct accounting practice (Appendix, p. 9-14, infra). It then relied on the noticed accounting principles as the central point in support of its decision. However, the issues of whether the taxpayer's cost allocation method and that proposed by the government accorded with "correct accounting

practice" were not raised in the Claims Court, or in the appellate court by either party.

Correct accounting practices, particularly as applied to a specific business situation, are hardly matters for judicial notice. Such practices are highly dependent on the specific business context involved, and are matters for expert testimony, rather than judicial notice. See, e.g., Thor Power Tool Co. v. Commissioner, 439 U.S. 522, 530-33 (1979); Union Stock Farms v. Commissioner, 265 F.2d 712, 724 (9th Cir. 1959) ("[w]e cannot take judicial notice of [basic good accounting practices]").[6]

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[6]Cases cited by the court for the proposition of taking judicial notice of authoritative texts (Appendix, p. 10, n. 3, infra) do not support the taking of judicial notice of ac-
(Continued)

The court below compounded its error by taking judicial notice without offering the notice and hearing to which petitioner was entitled under FED. R. EVID. 201(e):

> A party is entitled upon timely request to an opportunity to be heard as to the propriety of taking judicial notice and the tenor of the matter noticed. In the absence of prior notification, the request may be made after judicial notice has been taken.

By taking judicial notice of what it believed to be proper accounting practices, without affording notice or an opportunity to be heard, the court clearly departed from this Rule. Thus, this is not unlike the situation pre-

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counting practices. The cited cases involved patent matters in which the court took judicial notice of established scientific facts and definitions.

sented in Ohio Bell Telephone Co. v. Public Utilities Commission, 301 U.S. 292, 300 (1937) wherein Justice Cardozo, speaking for a unanimous Court, declared that the use of judicial notice of market trends constituted a denial of the "fundamentals of a trial." The requirements of notice and hearing apply equally to the appellate courts[7], and here the material improperly noticed was crucial to the decision.

The importance of affording parties an opportunity to be heard is borne out

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[7]See, e.g., Mutual Life Insurance Co. v. McGrew, 188 U.S. 291, 312 (1903); Turtle Mountain Band of Chippewa Indians v. United States, 490 F.2d 935, 945 (Ct. Cl. 1974); 10 MOORE'S FEDERAL PRACTICE §201.60(f) (2d ed. 1982). ("Appellate courts should exercise even greater caution than trial courts in the use of judicial notice if the party whose interest will be harmed by its use lacks an opportunity to be heard in opposition".)

in this case by the fact that one of the very accounting texts relied upon by the majority actually supports the taxpayer's cost allocation method. As Judge Bennett explained in dissent:

> [T]he texts cited do not support the use of the "value method" of financial accounting in this case. Seidler & Carmichael, Accountants' Handbook (1981), 20-31, 'Allocation of Costs', actually suggests that the 'accounting method' used by the taxpayer, the direct tracing of costs, should be used (footnotes omitted).

(Appendix, pp. 29-30, infra).[8] The relevance of the other two accounting

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[8]Compare the majority's reliance on Seidler & Carmichael (Appendix, p. 12, infra) ("[t]he value method [of allocating costs] is most commonly used.") with the dissent's, (Appendix, p. 30, infra) ("[the specific identification method] frequently is used for direct construction costs because these costs are directly related to the property being sold. This method should be used wherever practicable.") (emphasis in original).

texts noticed by the majority were also disputed by the dissenting judge. Surely, when three judges cannot agree on whether a matter is appropriate for judicial notice as well as the correct facts which are to be noticed, the party affected must be granted an opportunity to be heard.

The decision in this case sets a dangerous precedent by indicating that an appellate court is free to determine sua sponte whether a taxpayer has complied with what the court believes to be correct accounting practice. In effect, the court assumed the role of an expert witness based on independent research and interpretation of accounting texts and thereby expanded the judicial notice rule far beyond its intended scope. In

so doing, the court committed "clear error" (Appendix, p. 41, infra). This error is so egregious as to require this Court's review and the exercise of its supervisory powers.

CONCLUSION

For these reasons, a writ of certiorari should issue to review the judgment and opinion, cited herein, of the United States Court of Appeals for the Federal Circuit.

Respectfully submitted,

Greenberg, Traurig, Askew,
Hoffman, Lipoff, Rosen
& Quentel, P.A.
Attorneys for Petitioner
1401 Brickell Avenue, PH-1
Miami, Florida 33131
Telephone: (305) 579-0619

Melvin N. Greenberg, Esq.
Marlene K. Silverman,
Attorney at Law

ENTRY OF APPEARANCE

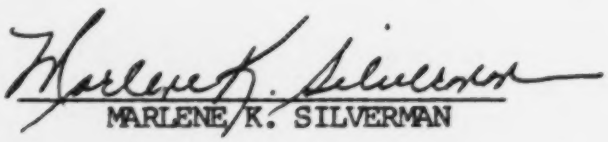
COMES NOW, MARLENE K. SILVERMAN, Attorney at Law, who hereby enters her appearance in this Court as counsel for Petitioner, August Urbanek, and the Estate of Irene Urbanek, Deceased, August Urbanek, Personal Representative.

Marlene K. Silverman
Attorney at Law
Melvin N. Greenberg, Esq.
Greenberg, Traurig, Askew,
Hoffman, Lipoff, Rosen
& Quentel, P.A.
Attorneys for Petitioner
1401 Brickell Avenue, PH-1,
Miami, Florida 33131
(305) 579-0619

By: Marlene K. Silverman
Marlene K. Silverman

CERTIFICATE OF SERVICE

I HEREBY CERTIFY that true and correct copies of the foregoing were mailed, postage prepaid, pursuant to Supreme Court Rules 28.3 and 28.4, to THEODORE D. PEYSER, Claims Court Section, Tax Division, Department of Justice, Washington, D.C. 20530 and to the SOLICITOR GENERAL, Department of Justice, Washington, D.C. 20530 on this 4th day of August, 1984.



MARLENE K. SILVERMAN

APPENDIX

[¶9374] August Urbanek and Estate of Irene Urbanek, Deceased, August Urbanek, Personal Representative, Appellants v. The United States, Appellee.

U.S. Court of Appeals for the Federal Circuit, Appeal No. 83-1262, 4/6/84. Affirming Cls Ct, 83-1 USTC ¶9389.

[Code Secs. 167 and 1011]

Basis: Allocation: Land and buildings: Depreciation. - The costs of improvements erected upon one tract of land were allocated to the basis of that tract as well as to the basis of an undeveloped adjoining piece of property. The former tract was sold by the taxpayer and his partner and they required the purchasers to lease the adjoining tract. The value of the leased tract depended on the improvements constructed on the sale property,

since without the benefit of the improvements on the sale property, the leased property would have had no appeal. As a result, costs were allocated in proportion to the fair market value of each tract. Due to the allocation, the basis of the sale property was reduced (originally the taxpayer had allocated all improvement costs to the sale property) and there was a corresponding increase in taxable partnership gain and the taxpayer's share of partnership income. Finally, no part of the construction costs reallocated to the leased property was depreciable. The improvements on the sale property provided an intangible benefit (leasing attractiveness) to the leased land but were not part of the

leased land. Back references: ¶1715.1958 and 4512.0576.

Before BENNETT, Circuit Judge, SKELTON, Senior Circuit Judge, and MILLER, Circuit Judge.

MILLER, Circuit Judge: This appeal is from the judgment of the United States Claims Court (2 Cl. Ct. 574 (1983)) that August Urbanek and the estate of his deceased wife, Irene Urbanek (with whom August Urbanek filed a joint income tax return) recover from the United States only the sum of $69,358.46 in tax, $693.59 in assessed penalties, $15,889.27 in interest paid, plus interest on the foregoing as provided by law together with costs to the defendant, for the calendar year 1972. The suit was based on a 1977 Notice of

Disallowance of August and Irene Urbanek's claim for refund of $173,268.43 plus interest. The $173,268.43 comprised a disputed deficiency in income tax of $139,897.46, interest of $31,972, and a late payment penalty of $1,398.97. The deficiency in income tax was based on August Urbanek's 50% distributive share of asserted additional income of a partnership from the sale of condominium units.[1] We affirm.

The factual background of this case found by the Claims Court rests on the stipulation of the parties and is set forth below (footnotes omitted).

> In 1969, taxpayer, August Urbanek, formed a partnership to develop a 5.5 acre tract of

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[1]Urbanek's share of the asserted additional income was $270,158.

land [in Boca Raton, Florida]. The project called for the construction of two condominium towers on .9 acre located roughly in the middle of the tract. On the surrounding land, the partnership constructed various amenities such as a parking lot, a putting green, a swimming pool and a marina.

Sales of condominium units followed a pattern which was not uncommon to developments in Florida in the 1970s. Each buyer received fee simple title to his condominium and to a pro rata share of a package consisting of the land on which the towers were located, of a road connecting the towers with the public street and of the amenities. The partnership retained title to the approximately 4.6 acres which surrounded the towers and upon which the amenities were situated. The retained land was leased for 99 years to the Boca Towers Condominium Association, a nonprofit Florida corporation formed by the taxpayer and his partner in 1971.

The association agreed to a yearly net rental of approx-

imately $160,000, with periodic increases geared to the consumer price index. The lease was negotiated between the partnership and the association at a time when the taxpayer and his partner were in control of both. Buyers of condominium units were required to become members of the association and to assume a pro rata share of the ground lease. Each buyer pledged his condominium as security for performance of his obligations under the lease.

At that time, Boca Raton limited the density of residential construction to 50.7 units per acre. This meant that the larger a tract of land a developer had, the more condominium units he could build. Construction did not, however, have to be evenly distributed over the tract. As in this case, the residential units could be concentrated in high-rise towers on a small portion of the land, so long as sufficient total land was dedicated to the project.

. . . . .

The partnership sold the condominium units starting in 1972. In calculating the gain from the sale of these units, the taxpayer subtracted from the sales price the cost of the .9 acre of land on which the towers were situated, plus the full cost of erecting the towers and the amenities. The government challenges this method of computation. In the government's view, the combined sale/lease package offered to prospective buyers enabled the taxpayer to defer some immediate income from the sale by converting sale proceeds into lease payments, thereby diminishing the effects of the progressive income tax. The government proposes to remedy this problem by reallocating some of the cost of construction to the lease, thereby lowering the cost of the units sold and commensurately raising the taxpayer's [sic partnership's] gain. The government relies upon Welsh Homes, Inc. v. Commissioner [60-2 USTC ¶9498], 279 F. 2d 391 (4th Cir. 1960), and the reallocation formula adopted in that case (now commonly known as the Welsh Homes formula).

The Claims Court awarded Urbanek only $85,941.32 ($69,358.46 in overpaid tax, $693.59 in overpaid penalties, $15,889.27 in overpaid interest, plus interest on the foregoing, of the $173,268.43 plus interest in suit. Costs of $219.41 were awarded the Government.

Opinion

The Claims Court found that the partnership's allocation of only the cost of the 4.9 acres of raw land to the leased land "does not reflect reality because the value of the lease--and the rent it commanded--reflected the expenses incurred on the project as a whole, not merely the cost of buying the land." We are satisfied that appellant has not shown that this finding is

clearly erroneous. Heisig v. United States, 719 F.2d 1153, 1158 (Fed. Cir. 1983). Our conclusion is stated with full recognition that the bona fides of appellant's method is not in question. However, irrespective of tax avoidance (or postponement[2]) considerations, reallocation may be deemed proper. Central Cuba Sugar Co. v. Commissioner [52-2 USTC ¶9390], 198 F.2d 214, 215 (2d Cir. 1952). Proper accounting practice is to allocate costs to fairly match such costs with related revenues. Seidler and Carmichael, Accountants' Handbook (1981), 20-31; Davidson and Weil,

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[2]The Claims Court remarked: "Of course, since the taxpayer sold the 4.6 acres in a later tax year, he was entitled to add those [reallocated] costs to his basis in the land and thereby lower his gain from that sale."

Handbook of Modern Accounting (1977), 17-14.[3] Thus, the Claims Court found that allocation of only the cost of the 4.9 acres of raw land to the leased land did not "fairly match" (i.e. "reflect reality") the costs incurred on the project as a whole with the rental revenue and condominium sales proceeds related to such costs.

Nor has appellant shown that the method of allocation used by the Claims Court, which the Government asserted in its amended answer to appellant's

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[3]We take judicial notice of authoritative texts cited herein. Werk v. Parker, 249 U.S. 130, 132-33 (1919); Nippon Kogaku (USA), Inc. v. United States, 673 F. 2d 380, 382 (CCPA 1982); Schott Optical Glass, Inc. v. United States, 612 F. 2d 1283, 1285 (CCPA 1979); In re Moureu, 345 F. 2d 595, 597 n. 4 (CCPA 1965); In re Hartop and Brandes, 311 F. 2d 249, 253 (CCPA 1962); In re Eisenhut, 245 F. 2d 481, 483 n. 2 (CCPA 1957).

petition, does not clearly reflect income. Appellant's burden to show an abuse of discretion is a heavy one. See Brown v. Helvering [4 USTC ¶1223], 291 U.S. 193, 203 (1934) (citing, inter alia, Lucas v. American Code Co. [2 USTC ¶483], 280 U.S. 445, 449 (1930)); Lucas v. Structural Steel Co., 281 U.S. 264, 271 (1930); Morgan Guaranty Trust Co. of New York v. United States [78-2 USTC ¶9753], 585 F. 2d 988, 997 (Ct. Cl. 1978). See also I.R.C. §446(b); cf. Thor Power Tool Co. v. Commissioner [79-1 USTC ¶9139], 439 U.S. 522, 546 et seq. (1979). The taxpayer's argument (and the dissenting opinion's position) that the tax allows a taxpayer to deduct as costs of goods sold all actual expenditures incurred in acquiring and

improving property merely begs the question of what costs are properly allocable to the condominiums. Those costs that are properly allocable are obviously deductible as costs of goods sold.

Appellant argues that the Government's formula distorts income by allocating costs in proportion to fair market value of the interests and sold and retained. However, such a method of allocation is in accord with correct accounting practice. Thus, Seidler and Carmichael, Accountants' Handbook, supra, states:

> The value method [of allocating costs] is most commonly used. Under this method, the allocation of costs is based on relative values, such as estimated sales prices or appraised values.

Davidson and Weil, Handbook of Modern Accounting, supra, teaches:

> The various methods used for this allocation include ... value methods (mortgage release prices, estimated selling prices, or appraisals)....

Morrison and Cooper, Financial Accounting (1975), 283, in discussing "basket" purchases, says:

> A method which is commonly employed to allocate the total acquisition cost to the individual assets involves estimating the current values of the individual assets, and prorating the cost to each asset according to the proportion of its current value to the total current value of all the assets acquired.

The value method of allocation was recognized by this court's predecessor in Du Pont de Nemours & Co. v. United States [73-1 USTC ¶9183], 471 F. 2d 1211, 1220 (Ct. Cl. 1973), which

describes Welsh Homes, Inc., supra, as an example of cases reaching "satisfactory solutions" in allocating costs between retained and transferred interests. See also Biscayne Bay Island Co. [CCH Dec. 7030], 23 B. T. A. 731, 735 (1931).

Appellant further argues that if any reallocation is made, it should be limited to the cost of the amenities constructed on the leased land. However, as found by the Claims Court, the expenditures which the partnership had incurred to improve the interest that was sold (namely the condominium complex and the amenities) also materially enhanced the rentability of the leased interest, which could not have been rented at the rates set but for such expenditures.

Therefore, we hold[4] that the Claims Court correctly determined that the cost of the condominium complex and the amenities should be allocated to both the condominium complex and the leased land retained by the partnership, according to their respective values.[5]

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[4]The dissenting opinion misstates the holding, which is premised on basic tax law and not on the circumstances of Maryland ground rent law, which was involved in Welsh Homes.

[5]The Claims Court explained that, under its method, the sales price of the units is divided by the aggregate value of the entire property, which consists of the sales price plus the value of the lease (i.e., the capitalized value of the lease, which the court determined to be nine times the annual rent to be received from the owners of the 108 units sold in 1972). The parties have apparently agreed to the following computation if the value method for allocation is held to be applicable:

Computation of "Cost of Condominiums Sold" per Claims Court Ruling

Value of Interest Sold (Sales per return).....$3,559,050.00

Value of Interest Retained

(Continued)

The dissenting opinion cites "uncontradicted evidence at trial [establishing] that the sale/ground lease arrangement used by the taxpayer

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$63,180 annualized rentals X 9....	$ 568,620.00
Aggregate Value of Interests Sold and Retained.....	$4,127,670.00
Ratio of Interest Sold to Aggregate Value = $3,559,050.00 / $4,127,670.00 = .8622418	
Cost of Improvements.....	$2,931,710.79
Cost of Land.....	$ 197,314.83
$496,941.06 X 108/272	
Aggregate Costs.....	$3,129,025.62
Multiply by Ratio of Value of Interest Sold to Aggregate Value..	.8622418
Cost of Goods Sold per Court's Opinion.....	$2,697,976.00
Cost of Goods Sold Per Return.....	$3,030,368.00
Cost of Good[s] Sold Per Court.....	$2,697,976.60
Adjustment to Partnership Return...	$ 332,391.40
Multiplied by Plaintiffs Interest .50	.50
Plaintiffs' Share of Adjustment	$ 166,195.70

was prevalent in the Boca Raton area," but such evidence does not indicate what allocation methods were used in those arrangements and whether or not the Government approved them. Even if they had used an allocation method similar to the one used by Urbanek and it could be shown that this passed muster on audit by the Internal Revenue Service, that would not tie the Government's hands in this case. Mertens, Law of Federal Income Taxation (1976; 1983 Supp.) §§6015-6017; see also Carlton's Estate, 298 F. 2d 415, 419 (2d Cir. 1962). Accordingly, the suggestion that the Government's position here represents a "sweeping change in the taxation of condominium sales" that should emanate only from the Congress is not well taken.

Finally, appellant argues that, alternatively, the partnership is entitled to depreciate any construction costs reallocated to the leased land, citing Treas. Reg. §1.167(a)-4.[6] However, the key phrase in the regulation is "if subject to depreciation allowances," and appellant merely begs the question by his reliance on the regulation. We are satisfied that the Claims Court correctly held that the reallocated costs are not subject to depreciation allowances. As the court pointed out, the condominium complex and

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[6]The regulation provides in pertinent part: Capital expenditures made by a lessor for the erection of buildings or other improvements shall, if subject to depreciation allowances, be recovered by him over the estimated life of the improvements without regard to the period of the lease. [Emphasis added.]

amenities merely lend an "intangible benefit" (enhanced rentability) to the leased land and are not a part of it, and it was the partnership that severed ownership of the land from ownership of the improvements, leaving it nothing to depreciate. See F.M. Hubbell Son & Co. v. Burnet [2 USTC ¶785], 51 F. 2d 644, 645 (8th Cir. 1931).[7]

In view of the foregoing, the judgment of the Claims Court is affirmed.

Dissenting Opinion

BENNETT, Circuit Judge: I respectfully dissent from the majority's

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[7]Like the Claims Court, "Insofar as D. Loveman & Son Export Corp. v. Commissioner [CCH Dec. 24,297], 34 T. C. 776, 806-08 (1960), aff'd [62-1 USTC ¶9147] 296 F. 2d 732 (6th Cir. [1961]), cert. denied 369 U.S. 860 (1962), may be read as suggesting that a taxpayer can depreciate an asset he does not own, the court is unpersuaded and declines to follow."

holding that the government may reallocate construction costs in accordance with the Welsh Homes formula (which the majority calls the "value method of allocation").

I

The majority is laboring under the illusion that the main issue in this appeal is the apportionment of costs in accordance with "correct accounting practice"--a theory that no doubt will surprise the parties since no one argued it.[1] The parties and the Claims Court

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[1]It is perplexing to note that the majority places great emphasis on its notion that the application of the Welsh Homes formula in this case is in accord with "correct [financial] accounting practice." In Thor Power Tool Co. v. Commissioner [79-1 USTC ¶9139], 439 U.S. 522 (1979), the Supreme Court cautioned against even the presumption of equivalency between tax and financial accounting, given their disparity of purpose. See discussion id. at 538-44; see also (Continued)

believed that the issue here was whether the Welsh Homes formula should be applied to the peculiar facts of this case under existing tax law.

Prior to the Claims Court's and the majority's decisions, it appeared that in the calculation of the cost of goods sold, a taxpayer should allocate to the interest sold the costs associated with that interest. The taxpayer in this

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Frank Lyon Co. v. United States [78-1 USTC ¶9370], 435 U.S. 561, 577 (1978); Commissioner v. Idaho Power Co. [74-2 USTC ¶9521], 418 U.S. 1, 15 (1974); American Automobile Assn. v. United States [61-2 USTC ¶9517], 367 U.S. 687, 693 (1961); United Grocers Ltd. v. United States [62-2 USTC ¶9763], 308 F.2d 634, 641 (9th Cir. 1962) ("[w]hile testimony relative to accepted accounting practice may properly be considered by the court, it is not conclusive in determining the legal tax consequences of any transaction").
(Continued)

case[2] simply allocated the costs of the improvements and the .9-acre parcel of land to the interest sold in fee simple (the condominium towers, the .9-acre tract of land on which the towers were located, and the amenities) and included the cost of the 4.6-acre tract of land in the basis of the retained interest (ground rent on the 4.6-acre tract of land).[3] This allocation has a basis

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[2]For the sake of simplicity, the actions of the partnership will be referred to as the "taxpayer."

[3]The government does not challenge the allocation of the cost of the 5.5-acre tract between the .9-acre lot sold and the 4.6-acre lot retained. See Treas. Reg. § 1.61-6(a) (1982).

both in common sense and tax law,[4] and serves as an affirmation of the principle that the term "cost of goods sold" means just that.

The government, however, was skeptical of such a simple allocation, and initially asserted that the rent charged for the ground lease was excessive, and attempted to invoke a theory whereby the "excess rent" payable under a long-term lease is capitalized and treated as proceeds from the sale of property. Doubtlessly in recognition of the fact that this "capitalization" theory had

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[4]With all due respect to the observation in Skoglund v. United States [82-1 USTC ¶9270], 230 Ct. Cl. 833, 834 (1982), that "[u]nfortunately, common sense and tax law are rarely even waving acquaintances."

not been met with judicial favor,[5] the government, in its amended answer in the Claims Court, tested a new theory: the application of the Welsh Homes formula outside the unique area of Maryland ground rents.[6] In Welsh Homes, where

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[5]See, e.g., Murry v. Commissioner [79-2 USTC ¶ 9565], 601 F. 2d 892, 893 (5th Cir. 1979); Mangurian v Commissioner [CCH Dec. 35,934(M)], 38 T. C. M. (CCH) 366, 375 (1979); Friedman v. Commissioner [CCH Dec. 34,482(M)], 36 T. C. M. 841, 851 (1977); Welsh Homes, Inc. v. Commissioner [CCH Dec. 23,568], 32 T. C. 239, 250-52 (1959), aff'd, 279 F. 2d 391 (4th Cir. 1960).

[6]In only one case has the Welsh Homes formula been applied outside this area, Connolly v. Commissioner [CCH, Dec. 33,474(M)], 34 T. C. M. 1379 (1975). In Connolly, the taxpayer constructed a cooperative apartment building on a parcel of land. The parties stipulated that the taxpayer "sold" leasehold interests in both the land and the building to cooperative apartment purchasers. Id. at 1381-82. Thus, the arrangement utilized in Connolly resembled that used in the Maryland ground rent setting where the building and its underlying land are both sold and leased. Moreover, the court in Connolly cautioned that "our disposition of this (Continued)

property interests in both the building and the underlying land are simultaneously retained and conveyed,[7] and thus the cost of the leasehold interest carved out of the whole "cannot be definitely shown," 279 F. 2d at 394 (emphasis added), the court approved the Commissioner's use of an allocation method whereby the costs of the entire interest are lumped together and attributed to the interest sold and the interest retained according to their respective values in the year of sale. Id.

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case can hardly have any useful precedential value in other cases where the matters in controversy are more sharply brought into focus against the background of a more clearly developed record." Id. at 1385.

[7]See Welsh Homes, 279 F. 2d at 393-94, for a description of the intricacies of the Maryland ground rent arrangement.

The factual disparity between the Maryland ground rent setting and the arrangement utilized by the taxpayer in this case is manifest, and, more important, the sine qua non of the Welsh Homes formula, that costs cannot be traced to the respective property interests, is conspicuously absent from this case.[8] The effect of the application of

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[8]In Welsh Homes, the court stated:

The cost of the land and the cost of the building, the constituent elements of the property which the builder has acquired are known, but in the building operation they have been incorporated into a single property and when a part interest in the whole--the leasehold-- is granted to the lessee and the reversionary interest or ground rent is retained by the lessor, it is impossible to ascertain what part of the value of these interests is attributable to the land and what part to the building. It follows that the cost of land and buildings must be allocated between the interest granted and the interest retained.

279 F. 2d at 395. Welsh Homes thus involves a situation where the same property is both leased and sold. In this case the sale and lease each (Continued)

the Welsh Homes formula to this case is that the plain reality of attributing costs to the interests to which they relate is ignored, and used in its stead is a wholly arbitrary means of allocating costs according to values without any recognition of the substance of the arrangement that the taxpayer utilized. In Frank Lyon Co. v. United States [78-1 USTC ¶9370], 435 U.S. 561, 583-84 (1978), the Supreme Court stated:

> [W]here...there is a genuine multiple-party transaction with economic substance which is compelled or encouraged by business or regulatory realities, is imbued with tax-independent considerations, and is not shaped solely by tax-avoidance features that have meaningless labels attached, the Government

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related to different, easily discernible properties, so there is no difficulty in tracing costs to the interest to which they relate.

> should honor the allocation of rights and duties effectuated by the parties.

The government has ignored the Supreme Court's admonition in this case, as the application of the Welsh Homes formula effectively restructures the transaction entered into by the taxpayer by allocating a portion of the cost of the improvements, which were sold in fee simple, to the interest retained by the taxpayer.

II

The accounting texts "judicially noticed" by the majority offer no support for the application of the Welsh Homes formula in this case. In the first place, the proposition put forth in the texts, that costs should be

matched with related revenues,[9] is so general as to have no great relevance to the specific facts of this case. At the very least, the proposition that the Government's proposed reallocation of costs is in accord with proper accounting practice would have to be established by expert testimony or by an accounting text that specifically addresses the type of arrangement utilized by the taxpayer.

Secondly, the texts cited do not support the use of the "value method" of financial accounting in this case. Seidler and Carmichael, Accountant's

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[9]Assuming relevance, under this general rule the taxpayer's allocation of costs was "correct," as the costs of the properties sold were matched with sales income, and the cost of the parcel retained was included in the basis of the rental interest.

Handbook (1981), 20-31, "Allocation of Costs," actually suggests that the "accounting method"[10] used by the taxpayer, the direct tracing of costs, should be used.

> Specific Identification Method. This method of cost allocation is based on determining actual costs applicable to each parcel of land. It rarely is used for land costs because such costs usually encompass more than one parcel. However, it frequently is used for direct construction costs because these costs are directly related to the property being sold. This method should be used wherever practicable.

Id. at 20-32 (emphasis added). Davidson and Weil, Handbook of Modern Accounting (1977), 17-14, "Cost Allocation," merely

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[10]The issue in this case is whether Welsh Homes should be applied, not the taxpayer's choice of an "accounting method" for a one-time deduction of costs.

lists four methods of accounting for capitalized costs, including the specific identification method, without any statement suggesting which method is most appropriate to the facts of this case. Finally, Morrison and Cooper, Financial Accounting (1975), 283, describes a "basket" purchase as follows:

> It occasionally happens that a firm acquires several assets all for one price with what is called a "basket" purchase. In this situation, the total cost of the several assets is known but the distribution of the cost to the individual assets may be uncertain. [Emphasis in original.]

The relevance of an allocation method based on "basket" purchases to the facts

of this case escapes me.[11]

III

The majority elevates the Claims Court's legal conclusion that the taxpayer's allocation of costs "does not reflect reality..." to a finding of fact subject to the "clearly erroneous" standard of review. This legal conclusion was based, in turn, on the court's perception that the taxpayer was free to

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[11]In Welsh Homes, 279 F. 2d at 395, the court was describing a "basket" purchase when it stated that "[a]llocation of costs is normally employed for the establishment of a cost basis of property when a taxpayer acquires an aggregate of assets for a single unallocated purchase price and subsequently sells a portion of the whole." (Citation omitted.) The court then noted that the case before it "presents the reverse of the situation," because the costs are known but it is impossible to trace these costs to the interest sold and the interest retained. Id. As previously mentioned, there is no difficulty in this case in assigning costs to the interest to which they relate, and thus Welsh Homes is inapplicable. See supra note 8.

manipulate the condominium price and ground rent in any proportion, 2 Cl. Ct. at 577, a proposition rejected in Murry v. Commissioner [79-2 USTC ¶9565], 601 F. 2d 892, 898 (5th Cir. 1979), and Friedman v. Commissioner [CCH Dec. 34,482(M)], 36 T. C. M. (CCH) 841, 850-51 (1977), because an inequitable balance of purchase price to rental payments would result in the reduction of the attractiveness of the offering to the public.[12] The uncontradicted evidence at trial established that the sale/ground lease arrangement used by

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[12]If, for example, the taxpayer offered the condominium units with a low purchase price (immediate gain to the taxpayer) and a correspondingly high rental payment (deferred income), one of the main tax advantages to the purchaser, deduction of interest payments, would be largely lost, as it is generally known that no deduction is permitted for nonbusiness rent.

the taxpayer was prevalent in the Boca Raton area, and that the independent (i.e., nontax) business purpose of the arrangement was to lower the purchase price of the condominium units and thereby facilitate their sale.

IV

In short, I would reverse and leave the taxpayer's allocation of costs intact, rather than substitute a means of taxation that is based more on the government's imagination than the economic substance of the transaction. The application of the Welsh Homes formula to this case is clearly unwarranted under existing tax law. Such a sweeping change in the taxation of condominium sales should come, if at all, from Congress, and not from "creative"

judicial opinions. See United States v. Byrum [72-2 USTC ¶12,859], 408 U.S. 125, 135 (1972).

UNITED STATES COURT OF APPEALS FOR THE FEDERAL CIRCUIT

AUGUST URBANEK and ESTATE OF IRENE URBANEK, Deceased, AUGUST URBANEK, Personal Representative,

NO. 83-1262

110-79T

Appellants,

v.

THE UNITED STATES,

Appellee.

JUDGMENT

ON APPEAL from the United States Claims Court

This CAUSE having been heard and considered, it is

ORDERED and ADJUDGED: Affirmed.

DATED April 6, 1984

Petition for rehearing, Denied
Circuit Judge Bennett,
dissenting, May 8, 1984,
Suggestion for rehearing
in banc, May 8, 1984.

ENTERED BY ORDER OF THE COURT

George E. Hutchinson, Clerk

_____
Clerk

ISSUED AS A MANDATE: May 21, 1984

COSTS: Against, Appellant

Filing Fee.....	$
Printing.....	$ 34.56
Total	$ 34.56

UNITED STATES COURT OF APPEALS FOR THE FEDERAL CIRCUIT

AUGUST URBANEK and ESTATE OF IRENE URBANEK, Deceased, AUGUST URBANEK, Personal Representative	)	
Appellants,	)	No. 83-1262
v.	)	
THE UNITED STATES,	)	
Appellee.	)	

ORDER

A petition for rehearing and a suggestion for rehearing in banc having been filed in this case,

UPON CONSIDERATION THEREOF, it is Ordered by the court that the petition for rehearing be, and the same is hereby, Denied. Circuit Judge Bennett would grant rehearing and has filed the attached statement.

The suggestion for rehearing in banc is declined.

FOR THE COURT

George E. Hutchinson, Clerk

May 8, 1984

cc: Melvin N. Greenberg
Theodore D. Peyser

UNITED STATES COURT OF APPEALS FOR THE FEDERAL CIRCUIT

AUGUST URBANEK and ESTATE OF IRENE URBANEK, Deceased, AUGUST URBANEK, Personal Representative, Appellants,	)	Appeal No. 83-1262
v.	)	On Petition for Rehearing and Suggestion for Rehearing In Banc
THE UNITED STATES, Appellee.	)	

BENNETT, Circuit Judge, dissenting.

I would grant the petition for all of the reasons set out in my dissent. Appellant, in his petition for rehearing, raises an issue that was not addressed in the dissent, and some comment is warranted.

I agree with appellant that "correct accounting practice" is not properly the subject of judicial notice.

See Petition for Rehearing and Suggestion for Rehearing In Banc pp. 11-13. The issue of whether a taxpayer's "method of accounting" conforms to "generally accepted accounting principles" is one of fact. See, e.g., Thor Power Tool Co. v. Commissioner, 439 U.S. 522, 530 and 533 (1979). Since this factual issue is obviously "subject to reasonable dispute," FED. R. EVID. 201(b), it is not properly the subject of judicial notice, particularly when appellant was not given an opportunity to be heard on this issue. FED. R. EVID. 201(e). See Union Stock Farms v. Commissioner, 265 F.2d 712, 724 (9th Cir. 1959). The majority's strong reliance on the "judicially noticed" accounting texts was therefore clear error.

[¶9389] AUGUST URBANEK, Plaintiff v. the UNITED STATES, Defendant.

U.S. Claims Court, NO. 110-79T, 6/3/83.

[Code Sec. 1011]

Basis for gain or loss: Allocation of construction costs: Condominium development: Units sold and land leased.--The taxpayer could not allocate the entire cost of the construction of condominium units and related amenities to the basis of the units that he built and sold. A portion of the cost was allocated to the basis of the surrounding land that was retained by the taxpayer and leased to the condominium owners. The sale of the units and the lease of the surrounding land were integral parts of the same transaction and

the court applied the formula in Welsh Homes, Inc., CA-4, 60-2 USTC ¶9498, 279 F. 2d 391, to allocate the total expenses of the project between the sale that resulted in immediate income, and the lease, which deferred income, in the same ratio as their respective values in the year of sale. Back reference: ¶4512.12.

[Code Sec. 167]

Depreciation: Condominium development: Costs allocated to land.--Although a portion of the costs of improvements for a condominium development were allocated to the basis of the land, the taxpayer could not claim depreciation on the costs because land is not depreciable. The taxpayer had severed ownership of the land from ownership of the

improvements and he could not claim depreciation on improvements he did not own. Back reference: ¶1715.1958.

Roger D. Osburn, Miami, Fla., for plaintiff. Glen L. Archer, Assistant Attorney General, Gilbert W. Rubloff, Department of Justice, Washington, D. C. 20530, for defendant.

OPINION

KOZINSKI, Chief Judge: At issue in this case is whether the taxpayer properly calculated the cost of certain condominium units which he built and sold in Boca Raton, Florida. The taxpayer allocated the entire cost of construction to the units themselves. The government argues that a portion of the cost should be allocated to the surrounding land, which was retained by the

taxpayer and leased to the condominium owners. Under the government's theory, the gain from the sale of the units would be higher than reported.

FACTS [1]

In 1969, taxpayer, August Urbanek,[2] formed a partnership to develop a 5.5 acre tract of land. The project called for the construction of two condominium towers on .9 acre located roughly in the middle of the tract. On the surrounding land, the partnership constructed various amenities such as a parking lot, a

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[1]The facts set forth are only those relevant to this opinion. Additional facts are contained in the stipulation filed by the parties and the court's oral findings entered at the end of trial.

[2]August Urbanek appears both personally and as representative of the estate of his deceased wife, Irene Urbanek.

putting green, a swimming pool and a marina.

Sales of condominium units followed a pattern which was not uncommon to developments in Florida in the 1970s. Each buyer received fee simple title to his condominium and to a pro rata share of a package consisting of the land on which the towers were located, of a road connecting the towers with the public street and of the amenities. The partnership retained title to the approximately 4.6 acres which surrounded the towers and upon which the amenities were situated. The retained land was leased for 99 years to the Boca Towers Condominium Association, a nonprofit Florida corporation formed by the taxpayer and his partner in 1971.

The association agreed to a yearly net rental of approximately $160,000, with periodic increases geared to the consumer price index. The lease was negotiated between the partnership and the association at a time when the taxpayer and his partner were in control of both. Buyers of condominium units were required to become members of the association and to assume a pro rata share of the ground lease. Each buyer pledged his condominium as security for performance of his obligations under the lease.

At that time, Boca Raton limited the density of residential construction to 50.7 units per acre. This meant that the larger a tract of land a developer had, the more condominium units he could

build. Construction did not, however, have to be evenly distributed over the tract. As in this case, the residential units could be concentrated in high-rise towers on a small portion of the land, so long as sufficient total land was dedicated to the project.

Perhaps because of the density ordinance, the value of the land was frequently expressed in terms of the number of condominium units it would support. Thus, raw land in the general vicinity of the project was selling for $6,250 to $10,344 per unit in 1970-71, which, multiplied by 50.7 allowable units, amounted to $316,875 to $524,440 per acre.

The partnership sold the condominium units starting in 1972.[3] In calculating the gain from the sale of these units, the taxpayer subtracted from the sales price the cost of the .9 acre of land on which the towers were situated, plus the full cost of erecting the towers and the amenities. The government challenges this method of computation. In the government's view, the combined sale/lease package offered to prospective buyers enabled the taxpayer to defer some immediate income from the sale by converting sale proceeds into lease payments, thereby diminishing the effects of the progressive income tax. The government proposes to remedy this

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[3]Federal income taxes for the 1972 tax year are in question here.

problem by reallocating some of the cost of construction to the lease, thereby lowering the cost of the units sold and commensurately raising the taxpayer's gain. The government relies upon Welsh Homes, Inc. v. Commissioner [60-2 USTC ¶9498], 279 F. 2d 391 (4th Cir. 1960), and the reallocation formula adopted in that case (now commonly known as the Welsh Homes formula).

DISCUSSION

A. The Welsh Homes Formula. The taxpayer argues vigorously that marketing of the project as partially a sale and partially a lease served a legitimate business purpose and that both the sale and lease prices were set at market rates. In the taxpayer's view, this establishes that the lease

payments represented only compensation for rental of the land and not deferred income from sale of the units, undercutting any justification for the government to reallocate costs between the two transactions. This argument might be persuasive if taxpayer had in fact established that the separate parts of the project represented separate transactions, each governed by independent market forces. However, the evidence paints a completely different picture: the sale of condominiums and the lease of the ground surrounding them were integral parts of the same transaction, flip sides of the same economic coin.

To reach this conclusion, one need only examine the method employed by the taxpayer in setting the supposedly fair

market rental under the ground lease. The taxpayer first set the fair market sales price of the 4.6 acres at $1.6 million. He came up with this figure by calculating that under the density ordinance, 4.6 acres of land could support 223 units; at $6,000 per unit, this amounted to approximately $1.6 million. The taxpayer next took one-tenth of this value, $160,000, as a fair market rental.[4]

The obvious flaw in the taxpayer's analysis is that he set the value of the 4.6 acres on the basis of a formula applicable to raw land capable of supporting condominium construction, but which is wholly inapposite to the land

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[4]The parties stipulated that one-tenth of the value of land was a fair market rental.

which was the subject of the lease. Whatever condominium-supporting capacity of the 4.6 acres of land originally had was lost when they were dedicated to the project. The only reason the taxpayer was allowed to put the two towers on the .9 acre of land was that he committed to leave the 4.6 acres undeveloped and thereby complied with the density ordinance.[5]

Contrary to taxpayer's assertion, therefore, the $1.6 million valuation of the 4.6 acres (and consequently the

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[5]There were additional reasons why the 4.6 acres could not support further condominium construction, and indeed, could support no use other than that to which they were dedicated. The land was the site of various amenities which were owned by the condominium buyers; any construction on the 4.6 acres would have interfered with use of the amenities and would have obscured the valuable views of many of the apartments.

$160,000 yearly rental) did not represent the fair market value of the land independent of the development project. Indeed, the evidence establishes that it is impossible to value the 4.6 acres for purposes of sale or rental, except with reference to the project as a whole. This is because no one other than the owners of the condominium units had any possible use for that land.[6] By placing the amenities on the 4.6 acres and dedicating the land to the project, the developer limited demand for the land entirely to the captive market

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[6]The amenities themselves were sold to the condominium owners who were then entitled to their exclusive use. There was no possibility, therefore, that someone might be interested in buying the 4.6 acres to operate a business unrelated to the condominium project, such as a public recreation park.

consisting of those persons who needed access to it for full enjoyment of their property.[7]

Moreover, individual rental payments under the lease could not be set independent of the sales price for each unit. The cash price for a unit plus the projected rental payments under the lease constituted an economic package which prospective buyers weighed as a whole. A lower sales price would have allowed taxpayer to charge higher rental

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[7]To be sure, after the lease was executed, the land would have a market value based upon the expectation of collecting rental income. However, that value would be entirely dependent upon the expected income to be derived from the lease and not upon the existence of a market for the land itself.

payments and vice versa.[8] At one extreme, the taxpayer might have maximized the sales price by charging no rent at all, because a condominium unencumbered by monthly lease payments can command more than the same unit subject to lease payments. At the other extreme, the taxpayer might have maximized rental payments by charging very little or even nothing for the units. Between those two extremes, the taxpayer was relatively free to set the price/rental ratio in making up the package he offered buyers. While buyers could refuse to accept the package as a whole, they did not have occasion to

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[8]Because few people pay cash, the trade-off for the individual buyer in terms of his monthly budget would be between the rental under the ground lease and the mortgage payments.

bargain as to the allocation between sale price and rental, that decision having been made entirely by the taxpayer and his partner when they executed the lease on behalf of the association.

Just as the income from the two portions of the project are inextricably linked, so the expenses incurred must be treated as an integral whole. Various costs went into the project: the price of the land, the cost of construction, promotional expenses, management fees, brokerage commissions, etc. Each of these expenses went towards making the entire project more marketable; it is impossible to point to a particular expense and say it contributed to one aspect of the project and not to another.

The taxpayer, however, allocated all of the costs connected with the construction of the units and amenities to the condominiums; he allocated only the cost of the 4.6 acres to the lease. This allocation does not reflect reality because the value of the lease--and the rent it commanded--reflected the expenses incurred on the project as a whole, not merely the cost of buying the land. Allocation of only the cost of the raw land to the lease was therefore entirely arbitrary. As noted above, the taxpayer was free to manipulate the relative income from the sale and the lease. To permit him to allocate expenses arbitrarily--without reference to the allocation of the incomes he has selected--can lead to a

serious and unjustified distortion in the gains reported for tax purposes.

The government proposes to remedy this problem by application of the Welsh Homes formula. Welsh Homes allocates the total expenses of the project between that portion of the transaction which results in immediate income (here the sale of the units) and that portion of the transaction which defers income (the lease), in the same ratio as their respective values in the year.[9] The

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[9]For purposes of deriving this ratio, the value of the units is set at their sales price and the value of the lease is the capitalized rental payments. It should be noted that here, as in Welsh Homes, we deal with a lease where the reversionary interest is of negligible value. If the lease were substantially shorter than 99 years and the reversionary interest were found to have significant value, it may not be appropriate to limit the value of the leased land to the capitalized rental payments.

taxpayer is left free to set relative sales and rental prices. However, he is then tied to that same ratio in allocating expenses.

Aside from making theoretical sense, the Welsh Homes formula is easy to apply because it takes the sales and rental prices as given and avoids the uncertainty of estimates as to market value. The formula first divides the sales price of the units by the aggregate value of the property which consists of the sales price plus the value of the lease.[10] The resulting ratio is applied to the project cost to determine

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[10]For reasons explicated at trial, the court determined that in 1972 the capitalized value of the lease was only nine times the annual rent to be received from the 108 units which were sold that year.

what portion should be allocated to the sale and what portion should be allocated to the lease.[11]

Because the Welsh Homes formula makes both theoretical and practical sense, the court adopts the defendant's position that it should be applied in this case.[12]

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[11]A numerical example of the formula's operation can be found in Welsh Homes. 279 F. 2d at 394. The court will not perform the calculations here because the parties have agreed to stipulate the precise amounts once the court rules as to the applicability of the Welsh Homes formula.

[12]For reasons which are not entirely clear, the Welsh Homes court thought it significant to analyze the precise nature of the relative interests of the buyer and the seller under state law. 279 F. 2d at 394-95. The logic of the Welsh Homes formula does not, however, turn upon such fine points of local law and plaintiff's attempts to so limit application of the formula is rejected. Indeed, there is no reason to limit the Welsh Homes approach to real estate transactions. The allocation formula would appear to be applicable whenever a taxpayer (Continued)

B. Deprciation. Having lost on his principal contention, the taxpayer suggests that he should be allowed to depreciate the costs which were allocated to the leased land under the Welsh Homes formula. The difficulty with taxpayer's argument is that he does not possess an asset which is capable of depreciation because all he has left is bare title to 4.6 acres of land. The rule, of course, is that land is not a wasting asset and is therefore not capable of depreciation. Houston Chronicle Publishing Co. v. United States [73-2 USTC ¶9537], 481 F. 2d 1240, 1258 (5th Cir.), cert. denied 414 U. S. 1129

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singles out for separate treatment an integral portion of a transaction (i.e., a portion which has no market value apart from the project as a whole) and obtains for it rental income or other deferred compensation.

(1973); Hoboken Land & Improvement Co. v. Commissioner [43-2 USTC ¶9595], 138 F. 2d 104 (3d Cir. 1943); Treas. Reg. §1.167(a)-2 (1956).

It is true, as plaintiff argues, that the costs allocated to the land under Welsh Homes are costs of constructing the improvements. However, the improvements merely lend an intangible benefit to the surrounding land; they are not part of it. It was taxpayer who chose to sever ownership of the land from ownership of the improvements, leaving himself with nothing to depreciate. See F. M. Hubbell Son & Co. v. Burnet, 51 F. 2d 644, 645 (8th Cir. 1931). He cannot now claim depreciation

of an asset he does not own.[13] Of course, since the taxpayer sold the 4.6 acres in a later tax year, he was entitled to add those costs to his basis in the land and thereby lower his gain from that sale.

CONCLUSION

Taxpayer's income for 1972 shall be recalculated pursuant to the Welsh Homes formula. The taxpayer is not entitled to depreciate any of the expenses allocated to the leased land pursuant to the formula. The matter is set for a status hearing at 10:00 a.m., on Thursday, June

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[13]Insofar as D. Loveman & Son Export Corp. v. Commissioner [Dec. 24,297], 34 T. C. 776, 806-08 (1960), aff'd [62-1 USTC ¶9147] 296 F. 2d 732 (6th Cir.), cert. denied 369 U. S. 860 (1962), may be read as suggesting that a taxpayer can depreciate an asset he does not own, the court is unpersuaded and declines to follow.

9, 1983, in Courtroom No. 4, Fifth Floor, National Courts Building, 717 Madison Place, N.W., Washington, D. C. 20005 to consider the course of further proceedings.[14]

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[14]Plaintiff's counsel, who practices outside of Washington, D. C., may participate by conference call to be placed by the court.

IN THE UNITED STATES
CLAIMS COURT

AUGUST URBANEK,

Plaintiff,

v. No. 110-79T

THE UNITED STATES,

Defendant.

ORDER
Filed June 14, 1983

A hearing was held on June 9, 1983. Based on counsel's representations it is ordered as follows:

(1) No later than June 21, 1983, defendant may file a revised calculation of the appropriate adjustment to plaintiff's 1972 tax liability. Plaintiff shall have 14 days to file a response, or may call the court to schedule a hearing for July 7, 1983.

(2) If the parties find that they are in agreement as to the calculations, they are to file by July 7, 1983, a stipulation as to the amount of plaintiff's judgment.

(3) Defendant, as prevailing party, shall be entitled to costs.

June 14, 1983

ALEX KOZINSKI
Chief Judge

IN THE

UNITED STATES CLAIMS COURT

AUGUST URBANEK and
ESTATE OF IRENE URBANEK, Deceased
AUGUST URBANEK, Personal
Representative,

Plaintiffs,

Docket No. 110-79-T

v.

UNITED STATES OF AMERICA,

Defendant.

July 18, 1983

STIPULATION

THE PARTIES STIPULATE AND AGREE that pursuant to the opinion of the Court filed on June 3, 1983, plaintiffs are entitled to a refund of the following: tax paid in the amount of $69,358.46, assessed penalties paid in the amount of $693.59, assessed interest

paid in the amount of $15,889.27, plus interest on the foregoing as provided by law.

THE PARTIES FURTHER STIPULATE AND AGREE that the costs to be taxed against plaintiffs pursuant to the Court's order dated June 14, 1983, are $219.41.

ROGER D. OSBURN
Greenberg, Traurig, Askew, Hoffman,
Lipoff & Quentel, P.A.
1401 Brickell Avenue, PH-2,
Miami, Florida 33131
Telephone: (305) 579-0748

GLENN L. ARCHER, JR.
Assistant Attorney General

GILBERT W. RUBLOFF
Attorneys for Defendant

CERTIFICATE OF SERVICE

I certify that service of the foregoing stipulation has, this 18th day of July 1983, been made on opposing counsel by mailing copies thereof, in a postage prepaid envelope, to the following address:

Roger D. Osburn, Esquire
Greenberg, Traurig, Askew, Hoffman,
Lipoff & Quentel, P.A.
1401 Brickell Avenue, PH-2,
Miami, Florida 33131

GILBERT W. RUBLOFF
Tax Division
Claims Court Section
United States Department
of Justice
Washington, D.C. 20530

IN THE UNITED STATES
CLAIMS COURT

No. 110-79T

AUGUST URBANEK and
ESTATE OF IRENE URBANEK, Deceased, AUGUST URBANEK, Personal Representative

JUDGMENT

v.

THE UNITED STATES

Filed July 18, 1983

Pursuant to the opinion of June 3, 1983, and the stipulation filed July 18, 1983, it was held that plaintiffs are entitled to recover.

IT IS ORDERED AND ADJUDGED this date, pursuant to Rule 58, that plaintiffs recover of and from the United States the sum of $69,358.46 in tax, $693.59 in assessed penalties,

$15,889.27 in interest paid, plus interest on the foregoing as provided by law together with costs to the defendant.

Frank T. Peartree

Clerk of Court

By:

Deputy Clerk

NOTE: As to appeal, 60 days from this date, see FRAP 4(a)

BILL OF COSTS
Filed July 18, 1983
IN THE UNITED STATES CLAIMS COURT

AUGUST URBANEK and
ESTATE OF IRENE URBANEK, Deceased
AUGUST URBANEK, Personal Representative

v. No. 110-79T

THE UNITED STATES

Judgment with costs having been entered in the above-entitled action on the 18th day of July, 1983, against plaintiffs, the clerk is requested to tax the following as costs:

Fees of the clerk	$_____
Fees of the reporter for all or any part of the transcript necessarily obtained for use in the case	_____
Fees and disbursements for printing	_____
Fees for witnesses; for statutory fees, see 28 U.S.C. §1821 (attach itemized listing)	_____

Fees for exemplification and copies of papers necessarily obtained for use in case	_____
Costs incident to taking of depositions	_____
Cost as shown on Mandate of Court of Appeals	_____
Other costs (itemize on attachment)	_____
Total	$ 219.41*

*Pursuant to the stipulation filed by the parties on July 18, 1983.

CERTIFICATION

State/District of , ss.
County of ,

I certify under penalty of perjury that the foregoing costs are correct and were necessarily incurred in this action and that the services for which fees have been charged were actually and necessarily performed and that a copy

hereof was this day mailed to with postage fully prepaid thereon. Executed on _____
(Date)

(28 U.S.C. ¶1746)

_____
(Signature of Attorney of Record)

_____

_____
(Address)

TAXATION OF COSTS

Costs are hereby taxed in the amount of $219.41* this 18th day of July, 1983, and that amount included in the judgment.

*Pursuant to the stipulation filed by the parties on July 18, 1983.

Frank T. Peartree
Clerk

By: _____
Deputy Clerk

NOTE: If taxed in favor of defendant payment thereof should be by check payable to "U.S. Treasury" and forwarded to defendant's attorney

of record with notice thereof to the Clerk. If in favor of plaintiff then payment will be via a Title 28 U.S.C. §2517 certification as provided for in Title 28 U.S.C. §2412(c)(1) and forwarded to plaintiff's attorney of record.

UNITED STATES CLAIMS COURT

AUGUST URBANEK and
ESTATE OF IRENE URBANEK, Deceased, AUGUST URBANEK, Personal Representative

NO. 110-79T

vs.

THE UNITED STATES

At the Claims Court held in the City of Washington, on the 18th day of July, A.D. 1983, judgment was ordered to be entered as follows:

Pursuant to the opinion of June 3, 1983, and the stipulation filed July 18, 1983, it was held that plaintiffs are entitled to recover.

IT IS ORDERED AND ADJUDGED this date, pursuant to Rule 58, that plaintiffs recover of and from the United States the sum of $69,358.46 in tax, $693.59 in assessed penalties,

$15,889.27 in interest paid, plus interest on the foregoing as provided by law.

ROGER D. OSBURN, ESQ.
Attorney of Record
1401 Brickell Ave., PH-2
Miami, Fl 33131

A true copy of record.

IN TESTIMONY WHEREOF I have hereunto set my hand and affixed the seal of said Court at Washington, this 18th day of July, A.D. 1983.

_____
Clerk, Claims Court.

Attest:
_____
Alex Kozinski Chief Judge.

STATUTORY APPENDIX

I. INTERNAL REVENUE CODE of 1954, as amended in 1972, (26 U.S.C.):

SEC. 61. GROSS INCOME DEFINED.

(a) General Definition. -- Except as otherwise provided in this subtitle, gross income means all income from whatever source derived, including (but not limited to) the following items:

(2) Gross income derived from business;

SEC. 1012. BASIS OF PROPERTY - COST

The basis of property shall be the cost of such property, except as otherwise provided in this subchapter and subchapter C (relating to corporate distributions and adjustments), K (relating to partners and partnerships),

and P (relating to capital gains and losses). The cost of real property shall not include any amount in respect of real property taxes which are treated under section 164(d) as imposed on the taxpayer.

(Aug. 16, 1954, ch. 736, 68A Stat. 296.)

II. TREASURY REGULATIONS

SEC. 1.61-3(a) GROSS INCOME DERIVED FROM BUSINESS.

(a) In general. In a manufacturing, merchandising, or mining business, "gross income" means the total sales, less the cost of goods sold, plus any income from investments and from incidental or outside operations or sources. Gross income is determined

without subtraction of depletion allowances based on a percentage of income to the extent that it exceeds cost depletion which may be required to be included in the amount of inventoriable costs as provided in §1.471-11 and without subtraction of selling expenses, losses or other items not ordinarily used in computing costs of goods sold or amounts which are of a type for which a deduction would be disallowed under section 162(c), (f), or (g) in the case of a business expense. The cost of goods sold should be determined in accordance with the method of accounting consistently used by the taxpayer.

SEC. 1.61-6(a) GAINS DERIVED FROM DEALINGS IN PROPERTY.

(a) In general. Gain realized on the sale or exchange of property is included in gross income, unless excluded by law. For this purpose property includes tangible items, such as a building, and intangible items, such as goodwill. Generally, the gain is the excess of the amount realized over the unrecovered cost or other basis for the property sold or exchanged. The specific rules for computing the amount of gain or loss are contained in section 1001 and the regulations thereunder. When a part of a larger property is sold, the cost or other basis of the entire property shall be equitably apportioned among the several parts, and the gain realized or loss sustained on

the part of the entire property sold is the difference between the selling price and the cost or other basis allocated to such part. The sale of each part is treated as a separate transaction and gain or loss shall be computed separately on each part. Thus, gain or loss shall be determined at the time of sale of each part and not deferred until the entire property has been disposed of.

III. FEDERAL RULES OF EVIDENCE

FED. R. EVID. 201(b).

(b) Kinds of facts. A judicially noticed fact must be one not subject to reasonable dispute in that it is either (1) generally known within the territorial jurisdiction of the trial court or (2) capable of accurate and ready deter-

mination by resort to sources whose accuracy cannot reasonably be questioned.

FED. R. EVID. 201(e).

(e) Opportunity to be heard. A party is entitled upon timely request to an opportunity to be heard as to the propriety of taking judicial notice and the tenor of the matter noticed. In the absence of prior notification, the request may be made after judicial notice has been taken.

Office - Supreme Court, U.S.
FILED
NOV 7 1984
ALEXANDER L. STEVAS
CLERK

No. 84-201

In the Supreme Court of the United States

OCTOBER TERM, 1984

AUGUST URBANEK, ET AL., PETITIONERS

v.

UNITED STATES OF AMERICA

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FEDERAL CIRCUIT

MEMORANDUM FOR THE UNITED STATES IN OPPOSITION

REX E. LEE
Solicitor General
Department of Justice
Washington, D. C. 20530
(202) 633-2217

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In the Supreme Court of the United States

OCTOBER TERM, 1984

No. 84-201

AUGUST URBANEK, ET AL., PETITIONERS

v.

UNITED STATES OF AMERICA

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FEDERAL CIRCUIT

MEMORANDUM FOR THE UNITED STATES IN OPPOSITION

Petitioners challenge the court of appeals' decision upholding a method used by the IRS to allocate the cost of a condominium project between the part of the project that was sold (the dwelling units and amenities) and the part that was leased (the surrounding land). The decision below is correct, the question presented is basically factual, and there is no conflict among the circuits or other consideration warranting this Court's review.

1. Petitioner is a 50% partner in a partnership that developed a condominium complex in Florida.[1] A local density ordinance required that the entire tract of land, consisting

[1]Petitioner filed a joint federal income tax return for the tax year at issue (1972) with his wife, who died in 1977. Petitioner accordingly instituted this suit in both his individual and his representative capacities.

of 5.5 acres, be dedicated to the condominium project (Pet. App. 45, 47-48). The partnership constructed two condominium towers on a 0.9-acre plot in the middle of the tract. The surrounding 4.6 acres were used as an open park to support various amenities, including a parking lot, a putting green, a swimming pool and a marina (*id.* at 45-46).

The partnership sold a number of the condominium units during 1972. In each case, the buyer received fee simple title to his unit and a pro rata share of a package consisting of the land on which the towers were situated, the roads, and the amenities themselves (Pet. App. 46). The partnership retained title to the 4.6-acre tract on which the amenities were situated, and leased that land to the condominium association for 99 years at a yearly net rental of about $160,000, with periodic increases geared to inflation (*id.* at 46-47). The lease terms were negotiated at a time when the partnership controlled the condominium association. Each condominium buyer as a condition of his purchase agreed to pay his pro rata share of the $160,000 annual ground lease and pledged his unit as security for performance of that obligation (*ibid.*). Because of the local density ordinance, the land was useless to anyone but the condominium buyers (*id.* at 54).

In calculating its gain from the sale of condominium units during 1972, it was necessary for the partnership to allocate its aggregate cost for the project as between the units sold and the 4.6-acre tract, which (as noted above) was retained by the partnership and leased to the condominium association. In making that calculation, the partnership allocated almost all the project costs — the total cost of constructing the towers and amenities, the cost of the land on which the towers stood, promotional expenses, management fees, and so forth — to the condominium units (Pet. App. 49, 57). The partnership allocated to the surrounding 4.6-acre tract only the original cost of that land in its raw, or unimproved,

state (*id.* at 49). The effect of this allocation was to maximize the partnership's cost (or tax "basis") for the units sold and thus minimize the gain that was realized on the sale of those units.

The Commissioner on audit challenged this allocation. He took the position that the condominium development was a single, integrated project, that the building and the surrounding land contributed mutually to each other's worth, and that the total cost of the project should be allocated between the units and the 4.6-acre tract in proportion to their respective fair market values. The effect of the Commissioner's reallocation was to reduce the partnership's basis in the units sold and thus to increase the gain currently realized and currently subject to tax.[2]

Petitioner paid the deficiency in tax and sued for a refund in the Claims Court, which sustained the Commissioner's position (Pet. App. 42-65). The court found as a fact that the allocation of costs reflected on the partnership's tax return "[did] not reflect reality because the value of the lease — and the rent it commanded — reflected the expenses incurred on the project as a whole, not merely the cost of buying the land" (*id.* at 58). "Allocation of only the cost of the raw land to the lease," the court concluded, "was therefore entirely arbitrary" (*ibid.*). The court noted that the partnership had complete freedom —evidenced by its fixing of a $160,000 annual rental fee for the 4.6-acre tract — to manipulate the relative amounts of income it would derive

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[2]Conversely, the Commissioner's reallocation had the effect of increasing the partnership's tax basis in the retained 4.6-acre tract, the cost of which will be recovered by petitioner when the partnership ultimately sells or otherwise disposes of that property. The court of appeals, following the Claims Court, rejected petitioner's claim for depreciation deductions on the construction costs allocated to the leased land (Pet. App. 18-19), and petitioner does not challenge that holding here.

from selling the units on the one hand and from leasing the land on the other (*id.* at 56, 58). Under these circumstances, the court concluded, "[t]o permit [the partnership] to allocate expenses arbitrarily — without reference to the allocation of the incomes [it] has selected —can lead to a serious and unjustified distortion in the gains reported for tax purposes" (*id.* at 58-59).

The court of appeals affirmed, one judge dissenting (Pet. App. 1-35). It held that petitioner had failed to prove that the Claims Court's findings of fact with respect to the proper allocation of costs were "clearly erroneous" (*id.* at 8-9). It noted that the Commissioner has considerable discretion in making cost allocations of this sort (*id.* at 11). And sustained the Claims Court's finding that the Commissioner had not abused his discretion in determining that the project's cost should be allocated according to the respective fair market values of the units sold and the land retained, according to the formula set forth in *Welsh Homes, Inc.* v. *Commissioner*, 279 F.2d 391 (4th Cir. 1960).

2. The decisions below are correct. The Claims Court found, and petitioners do not dispute, that the partnership acquired, developed, and marketed the entire 5.5-acre tract as a single condominium project. As the trial court observed, "[t]he cash price for a unit plus the projected rental payments under the lease constituted an economic package which prospective buyers weighed as a whole" (Pet. App. 55). The partnership was thus relatively free to decide for itself what portion of its income would come from sale of the units (and thus be currently taxable) and what portion would come from rental of the 4.6-acre tract (and thus be tax-deferred). And just as the partnership's rental income and sales income were inextricably intertwined, so its various expenses "went towards making the entire project more marketable," with the result that it was "impossible to point to a particular expense and say it contributed to one

aspect of the project and not to another" (*id.* at 57). The evidence similarly "establishe[d] that it [was] impossible to value the 4.6 acres for purpose of sale or rental, except with reference to the project as a whole," since "no one other than the owners of the condominium units had any possible use for that land" (*id.* at 54 (footnote omitted)). In short, the expenditures that the partnership incurred "to improve the interest that was sold (namely, the condominium complex and the amenities) also materially enhanced the rentability of the leased interest [viz., the 4.6-acre tract], which could not have been rented at the rates set [$160,000 per year] but for such expenditures" (*id.* at 14). Because the condominium complex and the 4.6-acre tract were thus mutually interdependent, the court of appeals correctly sustained the Claims Court's finding that the partnership's allocation of almost all the project costs to the units, and of nothing but the cost of the raw land to the 4.6-acre tract, was "entirely arbitrary" (*id.* at 8-9).

The court of appeals also correctly sustained the Claims Court's conclusion that the project costs should be allocated according to the respective fair market values of the units sold and the land retained. Under this allocation method, first articulated by the Fourth Circuit in *Welsh Homes*, the total cost of a single project is allocated between that portion of the transaction which results in immediate income (here, the sale of the units), and that portion of the transaction which defers income (here, the 99-year leasehold), according to the fair market values of the two properties involved.[3] In the present case, the fair market value of the property sold is the sales price of the units, and the fair market value of the property leased is the capitalized value

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[3]In *Welsh Homes*, the taxpayer developed real estate and (as here) sold and leased various interests in the property as part of a package arrangement. The Fourth Circuit held that, in order to reflect income clearly for tax purposes, it was proper to aggregate the taxpayer's various project costs and then allocate that sum between the interest

of the $160,000 annual rental fee.[4] Application of this formula here ensures that the allocation of costs will correspond to the allocation of income selected by the partnership, which "was relatively free to set the price/rental ratio in making up the package [it] offered buyers" (Pet. App. 56).

3. Contrary to petitioner's assertions (Pet. 13-16), the courts below did not undertake to "restructure" the condominium sales transactions, and this case therefore has nothing to do with *Frank Lyon Co.* v. *United States*, 435 U.S. 561, 583-584 (1978). That case involved a three-party sale and leaseback transaction, and this Court said that "the Government should honor the allocation of rights and duties effectuated by the parties" (*id.* at 584). But the IRS in this case has not attempted to restructure the condominium sales transactions or to depart from "the allocation of rights and duties" effectuated by petitioner and the condominium buyers. Rather, the question here concerns petitioner's unilateral allocation of costs, as between the properties sold and retained, in computing the gain he realized on selling the units. It is well established that the Commissioner is not required to accept a taxpayer's artificial allocation of costs

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conveyed and the interest retained. Accord, *e.g.*, *E.I. DuPont de Nemours & Co.* v. *United States*, 471 F.2d 1211, 1220 (Ct. Cl. 1973). See *Biscayne Bay Island Co.* v. *Commissioner*, 23 B.T.A. 731, 735 (1931). Petitioner errs in contending (Pet. 19-20) that the *Welsh Homes* formula should be used only in cases involving Maryland ground rents. As the Claims Court stated (Pet. App. 61 n.12), the logic behind that formula does not "turn upon such fine points of local law," but "would appear to be applicable whenever a taxpayer singles out for separate treatment an integral portion of a transaction (i.e., a portion which has no market value apart from the project as a whole) and obtains for it rental income or other deferred compensation" (*id.* at 62 n.12).

[4]The parties below largely stipulated to the computation that would be called for if the *Welsh Homes* formula were adopted. See Pet. App. 15-16 n.5, 60 n.10.

in such situations, even though the underlying business transaction is otherwise valid. See, *e.g.*, I.R.C. § 446(b) (granting Commissioner discretion to change a taxpayer's accounting method if the taxpayer's method does not "clearly reflect income"); Treas. Reg. § 1.61-6(a) ("when a part of a larger property is sold, the cost or other basis of the entire property shall be equitably apportioned among the several parts").[5]

4. Finally, there is no merit to petitioner's contention (Pet. 27-34) that the court of appeals erred in consulting standard accounting treatises for guidance as to the proper allocation of condominium project costs. Although generally accepted accounting principles are not controlling for tax purposes (*Thor Power Tool Co.* v. *Commissioner*, 439 U.S. 522 (1979)), they are obviously relevant. Treas. Reg. § 1.446-1(c)(1)(ii). See *Commissioner* v. *Idaho Power Co.*, 418 U.S. 1, 12 n.8 (1974) (citing standard accounting treatises as supporting Commissioner's reallocation of the taxpayer's basis in assets for depreciation purposes). Contrary to petitioner's assertion (Pet. 30), moreover, he had ample opportunity to present to the Federal Circuit his views regarding proper accounting practices, as the dissenting judge's opinions (Pet. App. 19-35, 40-41) make clear.

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[5]For similar reasons, petitioner errs in contending (Pet. 20-23) that the decision below conflicts with *Murry* v. *Commissioner*, 601 F.2d 892 (5th Cir. 1979). There, the IRS unsuccessfully sought to recharacterize future rental payments due on land surrounding a condominium complex as part of the proceeds of selling the units themselves, and sought to add the present value of those payments to the price actually paid by the condominium buyer in computing the seller's gain. Here, by contrast, the IRS contends, not that the lease payments should be recharacterized as sales proceeds, but that the costs of the project should be allocated on a different basis than that chosen by the taxpayer. There is thus no conflict between the two decisions.

It is therefore respectfully submitted that the petition for a writ of certiorari should be denied.

REX E. LEE
Solicitor General

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